REGULATORY FLEXIBILITY COMMITTEE

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MEETING MINUTES[1]

Meeting Date: September 8, 2005
Meeting Time: 10:00 A.M.
Meeting Place: State House, 200 W. Washington St., House Chambers
Meeting City: Indianapolis, Indiana
Meeting Number: 1

Members Present: Sen. Thomas Wyss, Co-Chairperson; Sen. James Merritt; Sen. Beverly Gard; Sen. Greg Server; Sen. Gary Dillon; Sen. Victor Heinold; Sen. Brandt Hershman; Sen. Allie Craycraft; Sen. Larry Lutz; Sen. Earline Rogers; Rep. Jack Lutz, Co-Chairperson; Rep. Robert Behning; Rep. James Buck; Rep. Timothy Neese; Rep. William Ruppel; Rep. Matt Whetstone; Rep. David Crooks; Rep. Ryan Dvorak; Rep. Win Moses.

Members Absent: Sen. Connie Sipes; Rep. David Frizzell; Rep. James Bottorff; Rep. Dan Stevenson.

[1] Exhibits and other materials referenced in these minutes can be inspected and copied in the Legislative Information Center in Room 230 of the State House in Indianapolis, Indiana. Requests for copies may be mailed to the Legislative Information Center, Legislative Services Agency, 200 West Washington Street, Indianapolis, IN 46204-2789. A fee of $0.15 per page and mailing costs will be charged for copies. These minutes are also available on the Internet at the General Assembly homepage. The URL address of the General Assembly homepage is http://www.ai.org/legislative/. No fee is charged for viewing, downloading, or printing minutes from the Internet.

Representative Jack Lutz and Senator Tom Wyss, Co-Chairmen of the Regulatory Flexibility Committee, convened the meeting at 10:10 a.m. Representative Lutz announced that the meeting's agenda would include: (1) a presentation of the Indiana Utility Regulatory Commission's (IURC's) annual industry reports by outgoing Chairman William McCarty; (2) comments by incoming Chairman David Lott Hardy; and (3) a summary of state telecommunications reform legislation presented by the Legislative Services Agency.

Annual Reports from the IURC

(1) Report on the Electric Industry[2]

After setting forth the agenda, Representative Lutz asked Chairman William McCarty to present the IURC's annual reports on the energy and telecommunications industries. Chairman McCarty thanked the Committee for the opportunity to discuss the Commission's activities and noted that this was his ninth presentation of the industry reports. He acknowledged the work of his fellow Commissioners and welcomed David Lott Hardy as the incoming Chairman.

Chairman McCarty began his final presentation to the Committee with a discussion of the electric industry. After presenting a graph[3] showing a ten-year comparison of residential electric bills for Indiana's five investor-owned utilities (IOUs),[4] Chairman McCarty observed that customer bills for American Electric Power (AEP) and Indianapolis Power & Light (IPL) have generally been lower than those of the other IOUs throughout the ten-year period.

Turning to the subject of merchant power plants, Chairman McCarty reported that the IURC had not received a petition for the construction of a merchant plant since March 2001. He noted that three approved merchant plant projects remain to be completed or cancelled: the Duke Energy Knox plant in Knox County, the Hammond Energy plant in Lake County, and the Acadia Bay plant in St. Joseph County. Chairman McCarty explained that if the start and completion dates for the construction of these plants, as set forth in the respective approval orders, are not met, the IURC would revoke the certificates of necessity and convenience for the projects. While ten merchant plants have been built and become operational in Indiana,[5] Chairman McCarty suggested that the lack of applications for new plants has been largely due to the rising cost of natural gas, which serves a fuel source for most merchant plants. Stating that he did not expect natural gas prices to stabilize for at least another two years, Chairman McCarty stressed that new, environmentally sound ways of using coal to generate electricity must be explored.

Chairman McCarty then discussed the status of regional transmission organizations (RTOs). He reminded the Committee that RTOs are independent entities that monitor electric reliability throughout a geographic region and coordinate the wholesale transmission system in that region. He reported that the Midwest Independent

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[2]See Exhibit 1.

[3]See Exhibit 2.

[4]Indiana's five investor owned utilities include: Indiana Michigan Power Co. (I & M); Indianapolis Power & Light Co. (IPL); Northern Indiana Public Service Co. (NIPSCO); PSI Energy, Inc.; and Southern Indiana Gas & Electric Co. (SIGECO).

[5]See Exhibit 2.

Transmission System Operator (MISO), which is based in Carmel, began operating both day-ahead and real-time energy markets on April 1, 2005. Under these new market initiatives, MISO schedules and dispatches generation in its Midwest region using a secure dispatch methodology based on the prices and operating characteristics offered by generation owners in the region. According to Chairman McCarty, this methodology results in the most economical use of resources at any given moment by taking into account all transmission constraints, while ensuring that sufficient generation is dispatched to meet demand.

In addition to enabling the more efficient and reliable transmission of electricity, MISO has also had a positive impact on the Indiana economy. Chairman McCarty noted that MISO employees more than 450 people in Indiana, with the average salary exceeding $60,000.

Finally, Chairman McCarty urged legislators to give the IURC authority over utility mergers. He noted that the pending acquisition of Cinergy by North Carolina-based Duke Energy will affect more than 700,000 Cinergy customers in Indiana. However, because the Indiana Supreme Court determined in a 1999 ruling that the IURC lacked authority over utility mergers,[6] the Commission will not be able to demand certain protections for Indiana customers. Chairman McCarty suggested that this lack of authority is especially problematic in light of the recently enacted federal Energy Policy Act of 2005. In repealing the Public Utility Holding Company Act of 1935 (PUHCA), which regulated the ways in which electric holding companies were allowed to merge into larger companies, the Act transferred many of the merger review functions from the Securities and Exchange Commission (SEC) to the Federal Energy Regulatory Commission (FERC) and to the states. However, because it lacks state statutory authority to review mergers, the IURC will not be able to exercise these newly delegated oversight functions. Chairman McCarty pointed out that Kentucky, which does have the authority to review mergers, has been able to win several concessions for its citizens in the Duke/Cinergy acquisition.

Having concluded his report on the electric industry, Chairman McCarty accepted questions from the Committee. Returning to the subject of electric rates, Senator Wyss asked whether the higher bills for customers of NIPSCO and SIGECO were the result of those utilities depending more on natural gas as a fuel source. Chairman McCarty responded by suggesting that the cost of coal, which is the primary fuel source for most of Indiana's generating plants, was more likely responsible for the higher rates. According to Chairman McCarty, coal costs have doubled over the past two years. In the case of NIPSCO, limited rail routes for the transportation of coal have increased the cost of coal for the utility.

Senator Gard then asked what percentage of the coal used in Indiana generating facilities actually comes from Indiana. Chairman McCarty deferred to Doug Gotham, Director of the State Utility Forecasting Group (SUFG). Mr. Gotham estimated that about 50% of the coal used comes from Indiana mines. Chairman McCarty explained that the high sulfur content of Indiana coal makes it more expensive for utilities to use, because the utilities must equip their plants with scrubbers and other technology to comply with environmental regulations.

Senator Dillon asked how the IURC's lack of authority over utility mergers would hurt Indiana customers. As examples of two areas in which the IURC will lack bargaining power with respect to the Duke/Cinergy merger, Chairman McCarty pointed out that the IURC will not be able to secure guarantees from the new entity concerning employment levels and levels of investment in Indiana facilities. He also pointed to the 2003 acquisition

[6] Indiana Bell Tel. Co. v. Indiana Util. Regulatory Comm'n, 715 N.E.2d 351 (Ind. 1999).

of Indiana-American Water by the German-based RWE AG. Kentucky, which has authority over utility mergers, was able to secure 43 commitments from the merged company, American Water. Indiana, on the other hand, was able to secure only 13 commitments from American Water, including a twelve-month commitment concerning the statewide workforce level and an agreement by the German owned company to submit its annual report to the IURC in English.

(2) Report on the Natural Gas Industry[7]

Following the discussion on the electric industry, Chairman McCarty turned the Committee's attention to the natural gas industry. He began by noting that U.S. wellhead natural gas prices were significantly higher entering the fall of 2005 than they were a year ago: $11/Mcf[8] in 2005, versus $5.50/Mcf in 2004. He warned that because of the higher wholesale prices, legislators would likely hear complaints from their constituents about increased heating bills during the upcoming winter. However, he reminded the Committee that the IURC has no control over prices on the unregulated wholesale market. Rather, costs at the retail level are largely a function of how well local delivery companies (LDCs) prepare for the heating season through price mitigation efforts, such as hedging, fixed purchase contracts, and portfolio management. Chairman McCarty noted that both the IURC and the Office of Utility Consumer Counselor (OUCC) have more closely scrutinized the gas procurement strategies of LDCs during gas cost adjustment (GCA)[9] proceedings. In fact, during the unprecedented price spike of the 2000-2001 heating season, the IURC disallowed GCAs requested by both Vectren and Citizens Gas.

While predicting that price mitigation efforts by LDCs would limit the impact of higher wholesale prices on retail customers in the short term, Chairman McCarty nevertheless cautioned that industry analysts have estimated that over the course of the upcoming winter, the average cost of heating for residential customers could increase by as much 70% over last year. Noting that natural gas in storage is well within the five-year historical range as the heating season approaches, Chairman McCarty stressed that storage is not the reason for the predicted higher prices. Rather, the upward pressure on prices is the result of both supply and demand factors. As cited in the IURC's report, aggregate demand for natural gas has been growing, driven by expanding economic growth across the United States and the increased use of natural gas as a fuel source for electricity generation.[10] At the same time that demand is growing, the U.S. supply of natural gas is tightening. While domestic natural gas production grew slightly in 2004, production levels from existing wells continue to decline, negating gains from the increased total number of producing wells.[11] As production nears capacity, the price responses to changes in supply

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[7]See Exhibit 3.

[8]Mcf is a unit of measurement denoting one thousand cubic feet of natural gas.

[9]Governed by the procedures set forth in IC 8-1-2-42, a gas cost adjustment (GCA) is an adjustment to an LDC's effective rates to reflect the fluctuating cost of purchased gas. An LDC may pass through the cost of purchased gas to its customers, but it is not allowed to profit from the pass-through.

[10] INDIANA UTILITY REGULATORY COMMISSION, 2005 GAS REPORT TO THE REGULATORY FLEXIBILITY COMMITTEE OF THE INDIANA GENERAL ASSEMBLY 9-10 (2005).

[11]*Id.* at 9.

or demand intensify: if production is at its peak and demand increases, prices will increase more significantly than if idle capacity existed.[12] Given the likely price increases due to these supply and demand dynamics, Chairman McCarty suggested that the LDCs' budget billing plans and assistance programs for low-income customers[13] will be crucial to many customers in the months ahead.

Finally, Chairman McCarty addressed "customer choice" programs in the natural gas industry. He explained that nationally, there has been a decrease in the number of natural gas marketers over the past few years, due to increasing gas prices, the financial problems of energy trading companies, and low profit margins. With fewer participating marketers and constantly changing market realities, choice programs provide a continuing challenge to LDCs, marketers, and regulators. In Indiana, NIPSCO has offered a customer choice program for both residential and business customers since 1998. Under the NIPSCO program, the entire residential and business customer base, which includes 647,439 residential customers and 58,578 business customers, is eligible to participate. However, actual enrollment is capped at 150,000 residential customers and 20,000 commercial customers. Chairman McCarty reported that as of May 2005, there were 50,051 residential customers and 8,729 business customers participating in the program, representing 33.4% of eligible residential customers and 43.6% of eligible business customers.

In concluding his presentation on the natural gas industry, Chairman McCarty suggested that Congress and federal regulators should consider imposing price caps on the wholesale natural gas market for the next six months. Acknowledging that his suggestion may not be politically popular, Chairman McCarty indicated that he was willing to make such a statement with respect to a commodity so vital to human safety and welfare.

(3) Report on the Telecommunications Industry[14]

Next, Chairman McCarty addressed the status of the telecommunications industry. He began by highlighting the annual statistics on the level of competition in the delivery of local telephone service. After three years of declining growth rates in the number of access lines served, incumbent local exchange carriers (ILECs) actually reported a 5.6% decrease in total lines in 2004. Still, ILECs maintain an overall share of 86.6% of all wireline services, and actually experienced a slight increase in the percentage of residential lines served, from 88.4% to 88.5%. At the same time, competitive local exchange carriers (CLECs) lost residential lines. However, CLECs did report a 2.1% growth rate in total access lines, due to an increase in business lines served: at the end of 2004, CLECs served 16.4% of business lines in Indiana. In displaying a map[15] showing the location of CLEC access lines in Indiana as of December 31, 2004, Chairman McCarty noted that most of the CLECs lines were concentrated in the metropolitan areas of Indianapolis, Evansville, South Bend, and Fort Wayne.

Regardless of the level of competition within the wireline sector, Chairman McCarty

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[12]*Id.* at 10.

[13]See Exhibit 4.

[14]See Exhibit 5.

[15]See 2005 TELEPHONE REPORT TO THE REGULATORY FLEXIBILITY COMMITTEE OF THE INDIANA GENERAL ASSEMBLY 5 (2005).

pointed out that the sector itself actually experienced a 4.7% loss in the total number of lines. The loss in wirelines was accompanied by significant growth in the wireless sector. From 2003 to 2004, the number of wireless subscribers in Indiana increased by almost 500,000 to 3,158,002. Still, Chairman McCarty stressed that wireless service is not yet a complete substitute for wireline service for most customers. As set forth in the IURC's report, in October 2004, the FCC reported Census Bureau data indicating that only 6% of customers have completely abandoned their wireline service.[16]

According to Chairman McCarty, one of the most significant developments in the telecommunications industry is the FCC's recent determination that ILECs will no longer have to provide unbundled local switching, which has been used by CLECs to serve small business and residential customers, at regulated prices. In its Triennial Review Remand Order (TRRO) issued in early 2005, the FCC eliminated the obligation of ILECs to provide Unbundled Network Elements--Platform (UNE-P) services to CLECs. In Indiana, UNE-P has been the preferred method by which CLECs have provided service to end users, with 69% of CLECs using UNE-P at the end of 2004. As Chairman McCarty explained, with UNE-P, a CLEC can lease all elements necessary to provide services at Total Element Long-Run Incremental Cost (TELRIC), a cost methodology that results in low UNE rates. UNE-P requires no CLEC-owned facilities, and the arrangement allows a CLEC to collect both long distance access revenue and reciprocal compensation for the exchange of local communications between the CLEC and the ILEC. However, in its order, the FCC found that alternatives exist for local switching functionality, including both switching provided by other non-ILEC wholesale providers and "facilities-based" switching, in which the CLEC itself owns all necessary facilities. While some CLECs have indeed taken advantage of these alternatives, Chairman McCarty noted that other CLECs have stopped taking orders for new residential customers or have left the market entirely. As evidence of this phenomenon, Chairman McCarty reported that there were 65 CLECs serving Indiana customers in 2004, compared with 79 CLECs in 2003.

Finally, Chairman McCarty addressed recent proposals for telecommunications deregulation. First, he pointed out that Indiana's three largest ILECs--SBC, Sprint, and Verizon--have alternative regulatory plans (ARPs) in effect. The result of negotiations between the companies and the OUCC, the ARPs provide for relaxed regulation of certain non-basic services, while requiring affordable rates for basic local service for residential and small business customers. As Chairman McCarty reminded the Committee, these alternative regulatory schemes were made possible by the legislature's enactment of Indiana's regulatory flexibility statute (IC 8-1-2.6) in 1985. According to Chairman McCarty, the statute has served Indiana well. Acknowledging the interest among legislators to further reform the regulatory environment, Chairman McCarty maintained that any proposed legislation should preserve the following functions of the IURC: (1) monitoring service quality; (2) ensuring universal service for Indiana customers; (3) arbitrating disputes between carriers; (4) overseeing telephone number and area code conservation efforts; and (5) collecting industry data. He also stressed that any new legislation should include a "pull back" provision--similar to the one included in IC 8-1-2.6--that would allow the IURC to reassert some or all of its jurisdiction over particular providers if warranted by the actions of the providers or changes in the industry or market conditions.

Chairman McCarty concluded his presentation by emphasizing the importance of a rational and civil transition of his duties to the next Chairman. He thanked the Committee

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[16] *Id.* at 9 (citing AT&T Wireless Services, Inc., WT Docket No. 04-70 FCC 04-255 (Oct. 26, 2004)).

members for the opportunity to work with them during his tenure and wished Chairman Hardy well.

(4) SUFG Report on Renewable Resources

Following Chairman McCarty's presentation, Doug Gotham, Director of the State Utility Forecasting Group, provided an overview[17] of the 2005 Indiana Renewable Energy Resources Study.[18] First, Mr. Gotham compared statistics on U.S. energy consumption versus Indiana energy consumption, based on the energy source used. In 2003, 40% of the total energy consumed in the United States came from petroleum sources. Natural gas and coal sources each accounted for 23% of the nation's total energy consumption, followed by nuclear energy, which represented 8% of the total energy consumed. Renewable resources comprised just 6% of the nation's total consumption. In Indiana, in the year 2001, coal accounted for 50% of the state's total energy consumption. Petroleum sources supplied 27% of the consumption, while natural gas accounted for 17%. Renewable resources represented only 1% of the energy consumed in Indiana.[19]

Turning from energy consumption[20] to electricity production, Mr. Gotham compared 2002 U.S. electricity generation by energy source with 2001 Indiana electricity generation by energy source. Coal was the primary fuel source used both nationally and at the state level, accounting for 51% of the electricity generated in the United States and 95% of that generated in Indiana. While natural gas was used to generate 18% of the country's electricity, it was used in just 3% of Indiana's production. Similarly, nuclear power, which accounted for 20% of U.S. electricity production, did not account for even a measurable percentage of Indiana's generation. The use of petroleum as a fuel source was negligible at both the national and state levels: petroleum (in the form of both liquids and coke) was the fuel source for 2.4% of U.S. production and 0.3% of Indiana production. Finally, renewable sources were used to generate 9% of the country's electricity and 1% of Indiana's electricity. Mr. Gotham noted that both across the nation and in Indiana, hydropower was the renewable source used most often to generate electricity, comprising 77% of the renewables used in the United States and 76% of those used in Indiana.

Having observed that renewables were responsible for a small percentage of both the energy consumed and the electricity produced both nationally and in Indiana, Mr. Gotham described some of the barriers to more widespread use of these alternative energy sources. First, he stressed that cost is the major barrier, with most renewable technologies having high upfront capital costs for needed infrastructure and equipment (e.g., hydroelectric dams, solar panels, and wind turbines). In Indiana, there is little incentive for making these significant capital investments, given the state's low electricity rates. Citing statistics from the Energy Information Administration, Mr. Gotham reported that Indiana had the fourth lowest electricity rates in the country in 2002, with only Kentucky, Wyoming, and WV having lower rates. According to Mr. Gotham, existing and potential producers may determine that the costs of investing in renewable generation

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[17]See Exhibit 6.

[18]See Exhibit 7.

[19]Percentages for Indiana energy consumption by energy source do not total 100%, because the state experienced a 5% net loss of electricity flow to other states.

[20]Mr. Gotham noted that the statistics presented on energy consumption include energy consumed not only as electricity, but as fuel and raw materials and for other uses.

would not pay off if consumers are not willing to pay a premium for renewables-based electricity.

Mr. Gotham explained that a second barrier to the development of renewables-based generation is the uncertainty surrounding certain technologies. For example, during much of year, Indiana lacks the high-intensity sunlight required for solar power. Similarly, given the rolling hills in the southern part of the state, Indiana lacks the completely flat topography that is so conducive to wind power in the Great Plains states. Still, the U.S. Department of Energy's most recent wind map indicates that some northern areas of the state would be potentially favorable to wind power, and in 2003 enXco proposed a 100 MW wind farm in Benton County. However, Mr. Gotham reported that little progress on the enXco project has been made.

Having noted the challenges to developing renewable-resource technologies, Mr. Gotham discussed some of the incentives for renewables contained in the federal Energy Policy Act of 2005. For example, the Act delayed the expiration of the federal renewable energy production tax credit by two years to December 31, 2007. It also expanded the full credit to some technologies that had previously been eligible for only a partial production credit, such as geothermal, open-loop biomass, and landfill gas technologies. Other sources of renewable energy that were previously not eligible for the credit at all, such as hydropower from existing dams, are now eligible for the credit under the Act. The Act further appropriated $2.2 billion through 2009 for research and development, including $590 million earmarked for biomass research. Still, the Act did not establish a national renewable portfolio standard; rather, the Act provides that by 2013, "to the extent economically feasible and technically practical," 7.5% of the total amount of electric energy consumed by the federal government during any fiscal year must be from renewable sources.[21]

Finally, Mr. Gotham discussed a number of specific renewable energy sources and their current and potential uses in Indiana. For example, energy crops, such as ethanol and soy diesel, are used in Indiana as transportation fuels. Other energy crops that could be used in Indiana include fast growing hardwood trees and certain grasses. Mr. Gotham noted that switchgrass, in particular, has a high energy content. However, there are a number of economic hurdles to the use of energy crops, including harvesting and transportation costs, other high-value uses for land, and the lower prices of competing fossil fuels, such as coal.

According to Mr. Gotham, organic waste biomass (primarily in the form of wood waste) represents Indiana's single largest source of renewable energy in terms of overall consumption. With respect to electricity production, organic waste biomass represents the second largest source of electricity generation in Indiana. Such generation is mainly fueled by landfill gas and municipal solid waste.

While fuel cells have received much attention nationally, Mr. Gotham noted that currently available fuel cells cost about $3,000/kW, which is roughly twice the cost of a large coal-fired plant and about ten times the cost of a natural gas-fired turbine. Still, Mr. Gotham acknowledged that considerable research has been devoted to the technology, and that the cost of cells would likely fall if ways to mass produce the cells can be developed.

Although fuel cells may be viable in the future, hydropower is currently the largest source of renewable electricity, both nationally and in Indiana. Indiana has about 60 MW of

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[21]Energy Policy Act of 2005, Pub. L. No. 109-58, § 203 (2005).

hydroelectric generating capacity, and the U.S. Department of Energy has identified another 66 MW of potential hydropower at existing dams. However, due to environmental permitting issues, only about 42 MW of this potential hydropower is considered viable.

Having concluded his presentation, Mr. Gotham considered a question raised by Senator Dillon concerning the costs and benefits of biofuels. According to Mr. Gotham, whether the costs of producing biofuels will be offset by the environmental and economic development benefits touted for such fuels will be determined in the years ahead, as the state moves forward with initiatives to encourage the use of these fuels.

(5) Introduction of Chairman David Lott Hardy

Following the presentation of the annual reports, Representative Lutz invited incoming IURC Chairman David Lott Hardy to address the Committee. Chairman Hardy thanked the Committee for the opportunity to speak and acknowledged Chairman McCarty's years of service to the state. Chairman Hardy promised to follow the statutes that govern his agency. He reported that the three incumbent Commissioners have been instrumental in familiarizing both him and the two incoming Commissioners with the procedures and functions of the Commission. He concluded his remarks by expressing optimism for the future of both the Commission and the state as a whole.

After the introduction of Chairman Hardy, Senator Merritt recognized Senator Server for his service in the General Assembly and wished him well in his new role as an IURC Commissioner.

(6) Summary of State Telecommunications Reform Legislation

Representative Lutz then asked Legislative Services Agency (LSA) staff to provide a summary of recent telecommunications reform legislation proposed or adopted by other states. Sarah Burkman, Attorney for the Committee, described the provisions common to many proposals and distributed materials summarizing various state legislation.[22]

Following LSA's summary, Senator Wyss announced that the Committee's next meeting would take place on October 3, 2005. The Co-Chairmen then adjourned the meeting at 12:15 p.m.

[22]See Exhibit 8.